

**Testimony of Robert Kurtter
Managing Director, U.S. Public Finance
Moody's Investors Service**

**Before the
United States House of Representatives
Committee on Ways and Means
Subcommittee on Oversight**

Hearing on the Transparency and Funding of State and Local Pensions

I. Introduction

Good morning Mr. Chairman, Congressman Lewis and members of the Subcommittee. My name is Robert Kurtter, and I am a Managing Director in the U.S. Public Finance Group at Moody's Investors Service ("Moody's"). Thank you for inviting Moody's to participate in today's hearing.

In my testimony, I will explain our views on the potential impact of transparency initiatives like H.R. 567 – the Public Employee Pension Transparency Act. We monitor developments like these because our assessment of government employers' pension plan assets and liabilities is one of many factors in our credit analysis of government-issued bonds.

We believe that H.R. 567 would increase access to, and comparability of, state and local government pension plan data. At the same time, H.R. 567 and other initiatives could increase the amount and complexity of the information disclosed. To the extent this or other initiatives help investors and government issuers have more informed discussions about the credit risks associated with these obligations, we believe they will create incentives for issuers to reduce unfunded pension liabilities. Depending on the specific measures taken, these actions could affect a government bond issuer's credit profile.

Of course, the decisions that governments make about their pension plans affect much more than their credit profile as bond issuers. Our role, however, is limited to providing opinions and research about issuers' likely ability and willingness to pay their bonds in full on a timely basis. For example, we do not take a position on whether or how a state or government should address a pension funding shortfall. Likewise, any commentary on policy initiatives that could affect issuer behavior should not be construed as an endorsement or criticism of any such initiative.

II. Transparency Initiatives Relating to Public Sector Pension Data

A. Overview of Recent Developments

For employers, pensions are a type of deferred compensation that leads to a long-term obligation to pay benefits in the future. In recent years, we have observed increases in state and local governments' unfunded pension liabilities. This growth has occurred for several reasons. First, at the prior peak of the stock market, some state and local governments enhanced benefits and/or reduced employer contributions. Second, the economic downturn significantly diminished the value of pension plans' assets. Third, adoption of early retirement incentive programs shifted costs from payroll to retirement systems. Fourth, demographic factors, including an aging workforce and the increasing life expectancy of beneficiaries, are adding to liabilities. These increasing liabilities have resulted in a situation where state and local governments have needed to increase their pension contributions at a time when declining revenues are also requiring them to impose budget cuts.

These developments have drawn the public's attention to some other issues relating to pension finance. For example, the Governmental Accounting Standards Board ("GASB") specifies that

government employers should use a discount rate for their pension obligations¹ that is the same as the employer's long-term expected future rate of return on the pension plan's invested assets. Given various investing strategies and asset mixes, different governments use different assumed rates of return, typically ranging from about 7.25-8.5%. Currently, there is widespread discussion about whether the existing disclosure standards about government pension plans remain appropriate and also about whether and to what extent government pension plans are underfunded. H.R. 567 and the GASB project discussed below are among the initiatives contributing to this discussion.²

Even as this discussion continues, some state and local governments already have reduced or announced planned reductions in the rates they use to calculate the present value of their future benefit payment obligations. These include pension plans in Alaska, California, Colorado, Illinois, Indiana, New York, Pennsylvania, Rhode Island, Virginia, the District of Columbia and San Francisco. Generally, these reductions have been in the range of 0.25 to 0.75 percentage points.

B. H.R. 567

H.R. 567, if enacted in its present form, would provide for the following, among other things. First, while a pension plan would still be permitted to prepare its funding report and financial statements in accordance with the GASB's standards, it would have to prepare and file supplemental financial schedules containing information prescribed by H.R. 567. For example, it would have to include information about the plan's funding status, funding and contribution projections for the next twenty years, and the plan's investment returns for the current and preceding five years. Most of this information already is reported in plan financial statements. H.R. 567, however, would set uniform calculation methods for certain disclosures made in the supplemental schedules. For example, H.R. 567 would require pension plans to calculate the value of their assets using a method based on the current fair market value of those assets. This is different from the current actuarial method, which uses a smoothed rate of return that averages investment performance over a period of years to reduce the impact of market volatility. Currently, private sector pension plans generally use this fair market value approach.

H.R. 567 also would require plans to calculate the unfunded, actuarial accrued liability ("UAAL") using a discount rate derived from a three-segment, modified yield curve based on Treasury rates. This approach would result in most state and local governments using lower discount rates to report their obligations in the supplemental schedules than they currently use to calculate and disclose their UAAL in their financial statements. This would result in reported pension liabilities increasing substantially.

Second, a central repository for pension data would be created. Each state and local government pension plan would have to file financial information about its pensions, including the new schedules prescribed by H.R. 567, with the Secretary of Treasury, which would make those reports available on a publicly accessible website.

¹ To estimate the value in today's dollars of future pension plan liabilities, an employer uses an interest rate to discount those liabilities to their present value. The lower the discount rate, the higher the estimate of the pension plan's obligation to pay future benefits.

² We also are aware of an initiative by the National Association of Bond Lawyers to provide guidance to counsel for public sector issuers about how to prepare disclosures about defined benefit pension plans.

C. The GASB Initiative

The GASB also is considering changes to its financial reporting rules for public sector pension plans. In June 2010, it issued a request for comment in the form of Preliminary Views (a “PV”) on pension accounting and financial reporting by public sector employers. The GASB is considering the comments it received on the PV and is expected to publish another consultation paper in the form of an exposure draft in June 2011.

If the PV is adopted as proposed, employers subject to the GASB’s disclosure requirements would be able to continue calculating their funding requirements as they do now, but they would have to use different methods to calculate the pension expense they disclose in their financial reports. In particular, the GASB is considering, among other things, whether or not to require public sector employers to: (1) recognize on their financial statements the unfunded portion of their pension obligations; (2) recognize faster any expenses caused by plan amendments, as well as certain actuarial gains and losses; and (3) use a lower discount rate for the portion of any plans that are expected to be unfunded.

With respect to item (3), the GASB has suggested that a reasonable long-term expected rate of return on the plan’s investments could continue to be the basis for discounting projected benefit payments to their present value, but only to the extent that the current and expected future plan net assets are sufficient to cover the future benefit payments. Benefit payments that are expected to occur beyond the point at which expected plan benefits are projected to be exhausted would be discounted to their present values using a high quality municipal bond index rate.³

D. Potential Impact of Initiatives on Amount of, Access to and Comparability of Pension Information

Moody’s believes that these initiatives, if adopted, would increase the amount of, access to and comparability of pension plan information, but they also could increase the complexity of the information disclosed. More specifically:

- Creating a publicly accessible, internet-based central repository for financial information about state and local government pension plans, as called for in H.R. 567, would make it easier for the public to obtain the relevant information. Likewise, requiring state and local governments to report certain information in a prescribed format in supplemental schedules, even if they already report such information elsewhere in their financial statements, could make it easier for the public to locate the relevant information.
- Prescribing uniform calculation methods for certain key metrics would facilitate comparability of information across state and local government pension plans. For example, H.R. 567 would require all of these employers to calculate the present value of their pension obligations using the same, modified yield curve based on Treasury rates of return. The GASB PV would require

³ This rate would change as the rate of return on the high quality municipal bond index fund changed. If this calculation method were in use now, we estimate that the prescribed discount rate likely would be somewhat lower than the long-term expected rate of return currently used by government pension plans but somewhat higher than a discount rate derived from a modified yield rate curve based on Treasury rates.

all public sector employers subject to its rules to use the same discount rate, based on a rate derived from an index of high quality municipal bonds, to calculate the present value of the unfunded portion of their pension obligations. While the discount rate is only one of a number of assumptions used in calculating pension liabilities, changes in this assumption would have a significant impact on the size of the reported obligation. Therefore, standardizing this assumption would enhance comparability even if other assumptions are not standardized.

- At the same time, requiring an employer to make multiple disclosures, using different calculation methods and in different places, about the same set of assets and liabilities could increase the complexity of disclosures and the time required to analyze the information. Some users of that information are likely to find that the resulting diversity of perspectives enhances their understanding. Others, however, might find the information more time-consuming to analyze and harder to understand.

E. Moody's Views on the Credit Implications of These Initiatives

If either or both of these initiatives result in a better informed dialogue about the credit risk of pension obligations, we believe this dialogue will create incentives for issuers to take actions to address unfunded pension liabilities. Governments have many options to increase the funded status of plans, including increasing government or employee contributions or adjusting benefits. Any changes in the funded status of a pension plan would be one of many factors that we would consider in our credit analysis. Depending on the specific measures taken, these actions could be positive, neutral or negative for bondholders.

As a credit rating agency, Moody's does not take a position on *whether* or *how* a state or local government should address a pension funding shortfall. Moreover, we do not rate the pension plans themselves. Rather, our opinions focus only on the potential implications for the creditworthiness of issuers' bonds and not on the wider implications for an issuer and its stakeholders of any actions that it takes. Finally, while we may comment on the credit implications for bondholders of various developments, including regulatory initiatives, that could affect the behavior of issuers, such commentary should not be construed as an endorsement or criticism of any such initiative or the conduct of any particular issuer.

Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.

ANNEX

To assist the Subcommittee in its deliberations, in this Annex I provide an overview of the key factors we consider in our credit analysis of issuers of state and local government bonds, including how we take pension liabilities into account, and our outlook on these sectors, including the assumptions that underpin our views.⁴

1. WHAT MOODY'S CREDIT RATINGS ADDRESS – AND WHAT THEY DO NOT

There has been a lot of attention paid recently to the debt levels of states and local governments. The term “debt” can refer to many things. When Moody’s uses the word “debt”, we are referring specifically to “bond debt”. We are not referring to any other obligations of the government, such as utility payments, salaries due to employees or pension liabilities. Our opinions speak only to the likelihood that a government-issued bond is likely to be paid in full on a timely basis, according to the contractual terms of that bond. This is what bond investors want to know. Therefore, when we use the term “default”, we are referring specifically to the failure to make payments to bondholders. We do not rate and are not referring to the default on any other type of obligation to any other person or entity.

Similarly, the term “credit risk” can mean different things to different people. When Moody’s uses the term “credit risk”, we are referring to the risk that an issuer will not pay the obligations due on its bonds when those obligations come due. As I explain below, we take into account all of an issuer’s major financial obligations as part of our analysis so that we can assess both the issuer’s ability and its willingness to meet its bond payment obligations.

We intend for our opinions to promote dialogue and debate among market participants about the relative credit risk of bonds issued in different regions and by different types of issuers. If people choose to consider our opinions, we expect them to use those opinions to supplement, and not replace, their own credit analysis, a task that is made easier by increased transparency and comparability of the information that issuers provide to us and the market generally.

2. KEY FACTORS IN OUR ANALYSIS OF STATE AND LOCAL GOVERNMENT BONDS

A. Overview

Set out below is an overview of the key factors we consider in our credit analysis of the U.S. public finance sector. By way of example, I will describe our analytical approach to the states. We focus on four broad factors:

1. *Economy*: We look at the breadth and diversity of the affected economy, including growth trends and comparative economic position to other, similar issuers.
2. *Finances*: We analyze information contained in financial statements as well as current budget information and compare this information to sector statistics for comparable issuers.

⁴ There are a significant number of unrated, U.S. public finance bonds. Therefore, my comments should not be generalized to the entire universe of public finance bonds because, historically, unrated issuers and bonds have demonstrated greater levels of credit risk and may continue to have quite different risk characteristics in the future.

3. *Debt Ratios:* Debt ratios are calculated to adjust for size (debt per capita) and wealth (e.g., debt to personal income) and compared to sector medians.
4. *Governance/Management:* We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.

All of these factors are important to our assessment of the state's degree of financial flexibility to meet the specific obligations it faces with respect to its bonds. We also look at each factor's impact on the other factors. Importantly, our focus is not *how* the state or local government achieves – or does not achieve – financial flexibility. Rather, we look to *whether* financial flexibility exists, and to what degree it exists.

B. State and Local Governments' Pension Liabilities

State and local governments' pension liabilities have long been part of our analysis and are factored into our opinions. We recognize that growing, unfunded pension obligations are creating challenges that these issuers must address, and we are monitoring the situation closely. We have taken, and will continue to take, rating actions where we believe an issuer's credit profile warrants it.

From an analytical perspective, pensions are a type of long-term debt obligation, and therefore they are incorporated into our debt ratio analysis. Ongoing contributions to the pension fund also represent a current budget cost, which we consider in our analysis of an issuer's finances. And finally, our governance analysis incorporates the way a government sponsor responds to developments regarding its pension obligations. How state and local governments manage their pension plans, however, is just one of many factors that we consider in our credit analysis of these issuers' bonds.

3. MOODY'S OUTLOOK FOR STATE AND LOCAL GOVERNMENTS

A. Credit Pressures and Credit Strengths

There is unprecedented financial strain on the U.S. public finance sector and this is reflected in the negative outlooks we have on all major sub-sectors in this market. For state and local governments, we hold this view for various reasons, including:

- A recovering but still fragile overall economy;
- Increased liabilities, such as pension and healthcare costs;
- Lingering fiscal pressures, which have required severe budget cuts, use of reserves, and other nonrecurring solutions to solve budget gaps; and
- Strained revenue sources because of persistent high unemployment and sagging real estate prices, along with attendant drags on taxes.

Despite these credit pressures, from the perspective of bondholders, bonds issued by the state and local governments continue to reflect a variety of credit strengths, including the following:

- Governments exist in perpetuity.
- State economies and those of some large cities are broad-based and diverse.
- State and local governments have strong incentives to pay bond debt. General obligation bonds are backed by the issuer's full faith and credit pledge, which an investor can take to court to

enforce. State and local governments also are motivated to treat other bond debt the same way so that they can continue accessing the markets to finance initiatives such as the construction of schools, roads and hospitals. For the same reasons, in the extremely unlikely event of a state default on general obligation bonds or related debt, we expect that investors' rate of recovery on their bonds would be very high.

- Bond debt, on its own or combined with unfunded pension liabilities, represents a relatively small proportion of state and local governments' total liabilities compared to other sectors, such as corporates. For example, debt owed to bondholders generally accounts for only 5-8% of state budgets and annual bond debt costs remain a relatively small share of expenditures. This means that governments have less incentive to default on these payments because non-payment would do little to solve major budget gaps.
- Federal monetary policies benefit state and local economies.
- State and local governments have a variety of powerful fiscal management tools at their disposal, including balanced budget requirements, authority to raise revenues, the ability to cut expenditures without reducing revenues (although large-scale state employee layoffs might depress economic growth), and, for states, the ability to cut or delay aid to local governments.

B. Widespread Defaults Not Expected

While states are facing a revenue and spending problem, Moody's does not see debt in the form of obligations to bondholders as the source of credit strain for most states. Annual bond debt costs remain a relatively small share of expenditures. In addition, most states do not face refinancing or material rollover risks. We could see a few more states turn to deficit financings to fund operating expenses, or restructurings to produce budget savings in 2011, but we expect those states to be the exception rather than the rule. For these reasons and because of the strong incentives states have to pay their bond debt, we do not expect any states to default on their bond obligations in the next twelve to eighteen months.

In the Moody's-rated local government sector, we expect a relatively small increase in defaults from historically low levels, but we do not expect a wave of defaults. One reason for the expected increase in bond defaults is that the states can reduce or delay their aid to local governments or cut programs so that local governments have to step in and fill the resulting funding gap. This is likely to exacerbate problems at the local government level. But we also expect that the majority of individual local governments will make the tough choices and painful budget cuts needed to continue making timely payments on their bonds. As a credit rating agency, we do not have views on which choices these issuers should make. Rather, we focus on whether the choices they make increase or decrease the likelihood that they will meet the contractual obligations under their bonds.

While we do not expect a wave of actual bond defaults by rated state and local governments, there have been situations in the past, for example in Harrisburg, Pennsylvania, where the risk of bond default seemed imminent but was averted. We expect there will likely continue to be selective instances of severe credit stress.

C. Assumptions

Moody's views on credit risk are predictions about the future and, as such, they are based on certain assumptions, or expectations, about what is likely (but not guaranteed) to happen. I have set out below a number of the assumptions we have incorporated into our outlook for the next twelve to eighteen months. We expect that:

- State and local governments will honor their contractual obligations to make bond payments because there are such strong incentives for them to do so.
- State and local governments will be able to continue accessing financial markets on roughly the same terms that are available to them now.
- State and local governments will continue to have sufficient budget flexibility, e.g., to cut costs and/or increase revenues, to meet the contractual obligations associated with their bonds.
- Bankruptcy laws will not change.
- The economic recovery will not be derailed by, for example, an oil price shock.

We recognize that a number of the assumptions above currently are the subject of debate. We constantly monitor the environment in which state and local governments operate, seeking information that is relevant to these assumptions. If at any time during our ongoing analysis, we were to begin seeing shifts that might call into question the appropriateness of these assumptions, we would reconsider those assumptions and, if we believe the facts and circumstances warranted it, revise and communicate our views to the market.